

Global Leaders Strategy

INVESTMENT LETTER | JANUARY 2020

The Global Leaders Strategy invests in a concentrated portfolio of market-leading companies from across the globe. We believe that companies that combine exceptional outcomes for their customers with strong leadership can generate high and sustainable returns on invested capital (ROIC) which can lead to outstanding shareholder returns.

SAILING BETWEEN SCYLLA AND CHARYBDIS

We were recently asked what our outlook is for 2020. Although we have limited ability to second-guess short-term changes in either the macro-economic environment or investor sentiment, the question made us reflect on different investment time horizons. In a previous investment letter that coincided with the strategy's third anniversary in 2018 ([Neither a marathon nor a sprint](#)) we wrote that, contrary to some of our peers, investing is neither a marathon nor a sprint but an odyssey—a life-changing journey in which we encounter temptation and danger on a regular basis. Two years later this analogy feels as apt as ever and like Odysseus, only by keeping our eyes on the horizon will we prevail against the ever-present challenges in equity markets and reach our investment destination. Homer's hero had to make many difficult choices on his journey back to Ithaca from the Trojan War with perhaps the most memorable being sailing between a six-headed monster (Scylla) and a whirlpool (Charybdis) on his voyage through the Strait of Messina. In our investing odyssey, two of the key dangers we face are supply-side disruption and overpaying for great companies. In many ways a competitor entering our company's marketplace and disrupting the relationship they have with their customers is akin to dealing with Scylla the six-headed monster—as customers end their relationships with a company the economic picture changes and our clients' capital can get savaged. Elsewhere, consistently overpaying for great businesses can have the Charybdis-esque impact of submerging our investment vessel and drowning the returns we can offer our clients. We take both of these risks incredibly seriously and remain perpetually paranoid about our companies' competitive positions, the price we pay and the prevailing value within the strategy. Indeed much of our energy is spent on managing these risks for our clients—significantly more than is spent making short-term predictions. Whilst we have little skill in predicting changes in economic activity or investor sentiment, the focus on managing our versions of Scylla and Charybdis will remain an ever present and indispensable part of our investing odyssey.



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FOLLOW THE BUYBACK BRICK ROAD

As we have discussed before, human psychology and herd mentality can result in certain investing concepts becoming overly simplified and detached from economic reality. Social proof is a powerful thing and over exposure to investment thinking can become accepted wisdom to the point when it is no longer questioned and the underpinning philosophy is lost. One of the best examples of this in recent years has been around the investment community's obsession with buying back equity. Such lemming-esque thinking has resulted in many investors believing that buying back equity always equates to good capital allocation—regardless of the price at which the shares are bought back or the other capital allocation alternatives available. This mantra has developed to the point where investors, especially those based in the US, expect excess capital to be diverted into buybacks. Indeed such is the belief in blindly buying back equity that it features in many of the company meetings that we share with other investors. As we have written about before purchasing equity is just one tool in a company's capital allocation tool kit and needs to be viewed holistically in tandem with internal investment¹ acquisitions, deleveraging and paying dividends. As Warren Buffett reminds us:

“The first law of capital allocation—whether the money is slated for acquisitions or share repurchases—is that what is smart at one price is dumb at another.”²

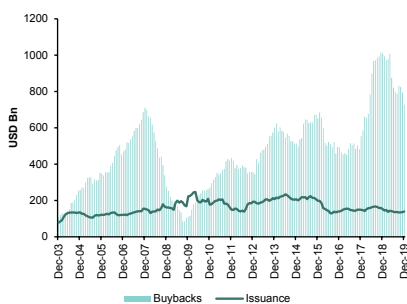
Against this backdrop management teams have responded to investor requests and have aggressively been buying back equity in recent years. As you can see from the charts below the buyback frenzy continued in 2019—led by the historical epicentre the US, where activity was boosted by the Trump administration's tax reforms in 2018. Indeed in the US, Europe and Japan equity markets continue to shrink as buyback activity exceeds equity issuance. What is perhaps the most startling aspect is that buybacks are largely pro-cyclical as management teams have a history of buying back shares in the good times and stopping buybacks, or even worse issuing equity, in the bad times. This is hardly surprising as it is human nature to extrapolate current trends in a linear fashion into the future. In addition, most CEOs and CFOs have backgrounds in functional parts of business, such as sales or operations, and limited training in return-based investing. Finally perhaps the biggest driver for this behaviour is incentive structures where many managers are rewarded on earnings per share³—a system that is built on the misguided belief that all earnings per share growth creates value.

¹ Internal investment is often the best allocation of capital in our opinion.

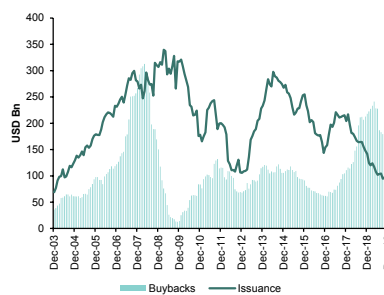
² Source: Berkshire Hathaway, Letters to Shareholders 2011, Warren Buffett

³ Typically unadjusted for the effects of buybacks and therefore open to manipulation.

U.S. Buybacks and Issuance



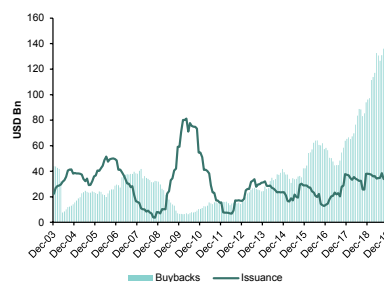
Pan Europe Buybacks and Issuance



Developed Asia ex Japan Buybacks and Issuance



Japan Buybacks and Issuance



Source: AllianceBernstein

The best way to explore this mind-set is with a simple hypothetical example. Let's consider a fictional company called "Megabuy Inc." which we expect to generate \$10m of free cash flow forever⁴ and has a 10% weighted average cost of capital (WACC). Financial theory dictates that any investment is worth the present value of its future cash flows which for Megabuy is a \$100m fair value (\$10m divided by the 10% WACC). Assuming Megabuy has 20 million shares outstanding gives a fair value per share of \$5 (\$100m/20m). Now to explore the buyback optionality and to keep things simple let's assume the management of Megabuy has access to interest free debt⁵ and decided to buyback 5 million shares at three prices—at \$2 in a time of panic (scenario A), \$8 in a time of euphoria (scenario B) and at \$5 (scenario C) when Megabuy shares are trading at fair value. As you can see below the different prices at which the shares are bought have a dramatic impact on the fair value per share of the company. The \$2 buyback increases fair value per share by 20% and the \$8 buyback decreases fair value per share by 20%—all of this is despite earnings per share having risen 33% from \$0.5 to \$0.67 in each scenario.

Megabuy Inc. Scenario	Current	A	B	C
Net Income (\$m)	10	10	10	10
Free Cash Flow (\$m) @ 100% conversion from Net Income	10	10	10	10
Weighted Average Cost of Capital (WACC) %	10.0%	10.0%	10.0%	10.0%
Gross Present Value (\$m)	100	100	100	100
Debt (\$) Financing for Buying Back Equity	0	10	40	25
Fair Value & Net Present Value (\$m)	100	90	60	75
Shares Pre-Buyback (m)	20	20	20	20
Shares Bought Back (m)	0	5	5	5
New Total Number of Shares (m)	20	15	15	15
Current Share Price (\$)	5.0	2.0	8.0	5.0
Fair Value Per Share (\$)	5.0	6.0	4.0	5.0
% Fair Value Per Share Change from Current	0.0%	20.0%	(20.0%)	0.0%
Earnings per Share (\$)	0.5	0.67	0.67	0.67
% EPS Change From Current		33%	33%	33%
Per Share \$ Value Change to Existing Shareholders		1.0	-1.0	0.0
% Per Share Change to Existing Shareholders		20%	-20%	0%
Per Share \$ Value Change to Selling Shareholders		-3.0	3.0	0.0
% Per Share Change to Selling Shareholders		-60%	60%	0%

Source: Brown Advisory analysis. This is a hypothetical scenario and does not represent an actual company nor a holding in the portfolio. It does not represent an actual buyback scenario and is used for illustrative purposes only.

⁴ Or 'in perpetuity' in financial parlance

⁵ A financing cost that is not a million miles away from where we are today.

The other important, and often forgotten point is that share buybacks do not create aggregate value—they are a transfer of value from one set of shareholders to another. This is evident in the fictional Megabuy example when in Scenario A (the \$2 buyback) the existing shareholders benefit at the expense of the selling shareholders as equity is bought back at \$2 which is below fair value per share of \$5. This action results in a \$1 per share (\$6 - \$5) accretion of value to the existing shareholders and a -\$3 (\$2 - \$5) loss to the selling shareholders. The net effect is a zero sum game⁶ as the 15 million shares retained by existing shareholders have grown in value by \$1 per share (+\$15m) and are offset by the 5 million shares that have been sold by the selling shareholders at a -\$3 loss of value (-\$15m). Conversely in Scenario B (the \$8 buyback) the selling shareholders benefit at the expense of the existing shareholders as equity is bought at a premium to the fair value of \$5. In this instance the existing shareholders lose -\$1 of value per share (\$5 - \$4) at the expense of the selling shareholders who gain \$3 of value per share (\$8 - \$5). Only when equity is bought back at fair value are both sets of shareholders treated equally which for Megabuy is Scenario C. Since it is the duty of company management to look after the interests of ongoing shareholders our belief is that buying equity at a discount to fair value should be the primary incentive for managers who are considering purchasing their shares. The crucial caveat is that any buyback has to present a better return for existing shareholders than all other capital allocation options. The ongoing controversy around buybacks stems from three recognised⁷ schools of thought amongst analysts and investors:

- 1. The Fair Value School**—When managers believe that their equity is on average fully valued, being undervalued and overvalued on different occasions. This belief requires a consistent level of buying back equity and negates the need for managers to have any investment skill in deciding when to purchase.
- 2. The Intrinsic Value School**—When managers believe they should only buy back equity when it trades at a discount to their company's fair value. This approach requires significant investing and analytical prowess on the part of managers but access to superior information and a disciplined process can result in significant value creation for existing investors.
- 3. The Boosting Accounting Results School**—When managers look to manipulate current accounting results with buybacks. Astonishingly the majority of CFOs believe that the *raison d'être* of purchasing their own shares is to boost earnings per share. As we demonstrate above with Megabuy this is a misguided, and frequently impure, motive as it flies in the face of value creating principles and can result in managers being rewarded for bad capital allocation. Buybacks have to be paid for and it is possible to grow earnings per share whilst destroying value for existing shareholders.

Given where we started this discussion it is no surprise that we believe in the intrinsic value approach to buying back equity. Our whole investment process is built on the belief that equity markets are inefficient over short time periods and management teams should be ready to deploy significant amounts of capital into buying back equity if it is the highest returning capital allocation alternative for existing shareholders. This requires discipline, process and a clear understanding of the fair value of their equity. The fair value approach, where equity is systematically purchased, sounds suspiciously like efficient market theory to us—the belief that equity markets are always efficient. In addition systematic buybacks have a material opportunity cost over other capital allocation options with the temptation for balance sheets to be permanently levered to levels that are seen as efficient in the good times and stretched in the bad times. Buying back equity to boost accounting results exhibits at best a lack of understanding of value creating principles and at worst it is the agency problem in full swing as the majority of corporate management teams are incentivised on earnings per share. Buying back equity to boost earnings per share that results in pay-outs for management teams can be completely self-serving and an act of daylight robbery if it destroys value for the ongoing owners of the business, the existing shareholders, and still benefits the CEO and CFO that pull the trigger.

As mentioned earlier the current canard that buying back equity is a prudent act of capital allocation and an effective way of returning capital to shareholders is fraught with danger. We believe that a very small proportion of managers and investors actually understand the role purchasing equity can have in the value creation process. Indeed we estimate that less than 10% of CFOs with whom we interact actually have a clear process for understanding the fair value of their shares and an even smaller number can actually articulate the internal rate of return they think they can generate for existing shareholders with buybacks. When assessing management quality we frequently say that we look for managers that think like investors—which we have dubbed 'investor managers'. Given current investor preoccupation with buying back equity, we believe this is a disservice to the managers with whom we look to invest our clients' capital. Perhaps a better definition is that we look to invest our clients' capital into managers that have the mind-set of return-orientated investors. Our impression is that the majority of investors remain content with blindly following each other like lemmings down the buyback road and over the capital allocation cliff into value destruction.

We hope you are having a productive and healthy start to 2020 and look forward to updating you on our progress as the strategy inches towards its fifth birthday in May.

The Global Leaders Team

⁶ (\$1 value per share x 15m shares) - (\$3 value per share x 5m shares) = 0

⁷ Source: Credit Suisse, 'Disbursing Cash to Shareholders' by Michael J. Mauboussin and Dan Callahan, 2014.

Disclosures, Terms and Definitions

Year	Composite Total Gross Returns (%)	Composite Total Net Returns (%)	Benchmark Returns (%)	Composite 3-Yr Annualized Standard Deviation (%)	Benchmark 3-Yr Annualized Standard Deviation (%)	Portfolios in Composite at End of Year	Composite Dispersion (%)	Composite Assets (\$USD Millions)	GIPS Firm Assets (\$USD Millions)*
2018	-2.2	-2.8	-9.6	11.0	10.5	2	N/A	303	30,529
2017	35.1	34.0	24.0	N/A	N/A	2	N/A	77	33,155
2016	-0.6	-1.4	8.0	N/A	N/A	2	N/A	38	30,417
2015**	1.2	0.7	-4.4	N/A	N/A	2	N/A	24	43,746

**Return is for period May 1, 2015 through December 31, 2015

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- *For the purpose of complying with the GIPS standards, the firm is defined as Brown Advisory Institutional, the Institutional and Balanced Institutional asset management divisions of Brown Advisory. As of July 1, 2016, the firm was redefined to exclude the Brown Advisory Private Client division, due to an evolution of the three distinct business lines.
- The Global Leaders Composite aims to achieve capital appreciation by investing primarily in global equities. The strategy will invest in equity securities of companies that the portfolio manager believes are leaders within their industry or country, as demonstrated by an ability to deliver high relative return on invested capital over time. The minimum account market value required for composite inclusion is \$1.5 million.
- This composite was created in 2015.
- The benchmark is the FTSE All-World Net Index. This index is a free float market cap weighted index representing the performance of the large & mid cap stocks from the FTSE Global Equity Index Series. The index covers Developed & Emerging Markets. Base Value 100 as at December 31, 1986. "FTSE®", "Russell®", "MTS®", "FTSE TMX®" and "FTSE Russell" and other service marks and trademarks related to the FTSE or Russell indexes are trademarks of the London Stock Exchange Group companies. An investor cannot invest directly into an index. Benchmark returns are not covered by the report of the independent verifiers.
- As of January 1, 2019, the composite benchmark was changed from Russell Global Large-Cap Net Index to the FTSE All-World Net Index. The change was applied retroactively from the composite inception date. The Russell Global Large-Cap Net Index was decommissioned as of 12/31/2018 and is no longer published.
- Composite dispersion is an equal-weighted standard deviation of portfolio returns calculated for the accounts in the composite for the entire calendar year period. The composite dispersion is not applicable (N/A) for periods where there were five or fewer accounts in the composite for the entire period.
- Gross-of-fees performance returns are presented before management fees but after all trading commissions, and gross of foreign withholding taxes (if applicable). Net-of-fee performance returns reflect the deduction of actual management fees and all trading commissions. Other expenses can reduce returns to investors. The standard management fee schedule is as follows: 0.80% on the first \$50 million; 0.55% on the next \$50 million; 0.45% on the next \$50 million; and 0.40% on the balance over \$150 million. Further information regarding investment advisory fees is described in Part II A of the firm's form ADV. Actual fees paid by accounts in the composite may differ from the current fee schedule.
- The three-year annualized ex-post standard deviation measures the variability of the composite (using gross returns) and the benchmark for the 36-month period ended on December 31. The 3 year annualized standard deviation is not presented as of December 31, 2015, December 31, 2016 and December 31, 2017 because 36 month returns for the composite were not available (N/A) and the composite did not exist.
- Valuations and performance returns are computed and stated in U.S. Dollars. All returns reflect the reinvestment of income and other earnings.
- A complete list of composite descriptions, policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.
- Past performance does not indicate future results.
- This piece is provided for informational purposes only and should not be construed as a research report, a recommendation or suggestion to engage in or refrain from a particular course of action or to make or hold a particular investment or pursue a particular investment strategy, including whether or not to buy, sell or hold any of the securities mentioned, including any mutual fund managed by Brown Advisory.

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The **FTSE All-World Index** is a market-capitalisation weighted index representing the performance of the large and mid cap stocks from the FTSE Global Equity Index Series and covers 90-95% of the investable market capitalisation. The index covers Developed and Emerging markets and is suitable as the basis for investment products, such as funds, derivatives and exchange-traded funds. FTSE® is a trade mark of LSEG and is used by FTSE under licence.

ROIC is a measure of determining a company's financial performance. It is calculated as NOPAT/IC; where NOPAT (net operating profit after tax) is (EBIT + Operating Leases Due 1-Yr)*(1-Cash Tax Rate) and IC (invested capital) is Total Debt + Total Equity + Total Unfunded Pension + (Operating Leases Due 1-Yr * 8) – Excess Cash. ROIC calculations presented use LFY (last fiscal year) and exclude financial services.

Earnings Per Share (EPS) is calculated as a company's profit divided by the outstanding shares of its common stock.

Free Cash Flow (FCF) represents the cash a company generates after accounting for cash outflows to support operations and maintain its capital assets.

Weighted Average Cost of Capital (WACC) is a calculation of a firm's cost of capital in which each category of capital is proportionately weighted.